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THE THEORY OF BUSINESS PROFITS.

I must respond, on behalf of my wife and myself, to the friendly challenge of General Walker contained in the last number of this journal. In a note to his article on the source of business profits, he quotes from the *Economics of Industry*, "The earnings of management of a manufacturer represent the value of the addition which his work makes to the total produce of capital and industry," and says: "If this remark is to be taken literally and strictly, I do not see why it does not express precisely the same view of the source of profits as is here sought to be set forth. In that case, I gladly yield all claim to priority in its statement." It is certainly to be taken literally. I am very nearly in agreement with General Walker's Theory of Profits; but there is, I think, a real though small difference between us. I do not regard the analogy between rent and the earnings of exceptional ability as confined to the task of business management. I hold that, whatever be a man's occupation, that part of his earnings "which he owes to his education may be regarded as a kind of *profit* on the capital invested in it; that part which he owes to exceptional natural qualities may be regarded as a kind of *rent*,—that is, it is the income derived from an agent of production, the supply of which is determined by natural causes, and not by the deliberate outlay of human effort for the sake of future advantage." (*Economics of Industry*, p. 110.)

As I said in your last number, when asking Professor Laughlin's indulgence, the *Economics of Industry* suffered from not having space to treat properly some of the difficult problems which were raised in it. One of the chief of these relates to the causes that determine Earnings of Management. But what was said on the subject in that little book was the product of many years' thought; and it claims to contain the outlines of an answer to just that question to which General Walker, if I understand him rightly, addresses himself in your last number. So that I cannot agree with him that there has been a *lacuna* in the theory of economics in that place where the discussion of the causes that determine the earnings of management ought to have been.

No economist in any country has, I think, explained the services which the undertaker renders with such graphic force as he has. Some things that he has said on this point remind me of passages of Adam Smith, which one can read and reread, and every time learn from them something new. The effective demand for the work of business management is based on the value of these services to the community; and, on this side of the question, the *Economics of Industry* is in harmony with General Walker's view, though I am ready to admit that any comparison between the two must be to the disadvantage of the former.

But the value of the undertaker's services conforms to the general law that value is determined by the forces of demand, on the one hand, and the forces to be overcome before supply is forthcoming, on the other; equilibrium being found where these two forces are equal to one another. And, on the side of supply, I cannot entirely accept General Walker's doctrine.

My own position is this. First, suppose that all people were born with equal natural talents, so that the industrial ability of every one depended entirely on the trouble and expense devoted to his education. In that case, the expenses of production of skilled work of any kind, the supply price at which any given amount of it could be obtained, would exceed the wages of ordinary labor by what was sufficient to repay the cost of the education required for it (*Economics of Industry*, Bk. II., ch. viii., § 1); but, in estimating this, we must remember that the expense had generally to be borne by parents who, for various reasons (*Ibid.*, §§ 2...), could not generally adjust on strict capitalistic methods their outlay to their expectation of the advantage it would bring in extra wages, etc., to their children. Among these are difficulties which a lad may find in getting access to the special training and the start in life required for a skilled trade other than his father's.

Next, it is argued (*Ibid.*, ch. ix.) that the same general reasoning applies to the supply price of business power. Even the difficulties of getting the necessary special training, and of making a start as a business man, resemble in many respects the special difficulties of getting access to the training required by, say, a glass-blower, or of starting with a connection in the profession of law or medicine.

But the business man who has little or no capital of his own must enter into partnership or hire himself out as business manager to a private firm or a public company; or, lastly (and this we may take as the typical case), he must borrow. It is then argued (*Ibid.*, ch. xii., § 1) that these borrowings, whatever form they take, involve a new set of risks, which may be called *Personal Risks*, and are in addition to the *Trade Risks* that are inseparable from business in his trade. The supply price, therefore, at which business ability, in command of the requisite capital, will be forthcoming, consists of: (a) the supply price of the ability itself; together with (b) the supply price of the bringing together of that ability with the capital required to give it scope, or, to look at the same thing from another point of view, Insurance against Personal Risks; together with (c) the supply price of the capital employed, or interest.

On the supposition, then, that all people have equal natural talents, I should find no scope for a comparison between the Earnings of Management and Rent. I agree with General Walker that the man who had got the best business training and managed his business best would almost inevitably be the one who would cost the least to the community in proportion to the services he rendered it; and that, putting aside cases of fraud, illegitimate combination, monopoly, etc., the cost of production of things would be increased, and not diminished, if the item in them which consists of business earnings were saved, but the services of business men in engineering and superintending production were lost. But this does not seem to me to justify the statement that normal earnings of management do not enter into (cost or) expenses of production. If a man did not paint the outer woodwork of his house, it would decay rapidly; and he would lose more than he would gain. The expense of house room would certainly be greater if paint were not used than it is now. But that does not justify us in saying that the price of painting is not one of the expenses of production of house room.

Next, to take account of the fact that natural talents are not equal. The talents given by nature resemble that part of the fertility of land which is, in common though loose phrase, inherent in the soil. Man cannot produce them at all; and,

therefore, they have no expenses of production, they have no supply price. When we want to find the relation between the value of corn and its expenses of production, we are forced to look at that corn which was raised on the margin of cultivation (to use a metaphor, for it is nothing else), so as to just pay its expenses without allowing anything for rent. The rent paid by any corn grown under more favorable conditions is determined by the price—that is, under normal conditions by the expenses of production—of that which is grown on the margin of cultivation. Rent is determined by price: it does not determine price. This, as General Walker has well explained, is what Ricardo meant by saying that rent does not enter into price. This phrase is not very happy, because the sense in which it has to be taken in order to make it true is not a very natural one. Most people take it in some other sense; and then they despise Ricardo, unless they are very dull and believe it in spite of not understanding it, and then they make other people despise Ricardo all the more.

I hold that in the same way the expenses of production of calico, in so far as they consist of manufacturer's earnings of management, are the supply price or expense of production of the manager's abilities, together with that of his capital, together with that of the task of getting him and his capital together. The supply price of the business man's abilities must be taken on the assumption that his mind was like land on the margin of cultivation, that is, not that it made *no* return to the capital and labor spent in educating it, but that it made only ordinary profits,—*i.e.*, that it made (in addition to interest on the material capital used by him) just enough to pay the expenses of production of his business ability, without allowing anything for rent. Those who have exceptional natural abilities (and average good fortune) get earnings exceeding the earnings of similar manufacturers whose minds are on the margin of cultivation, and this excess I proposed to call rent. The analogy already quoted from the chapter on the Supply of Skilled Labor is continued in the chapter on Earnings of Management (p. 144) thus:—

Business men are chosen by a process of natural selection from among many millions of competitors. For many employers of labor,

in some parts of England more than half, have risen from the ranks of hired labor. Every artisan who has exceptional natural abilities has a chance of raising himself to a post of command, and is in fact a candidate for the prizes that may be earned by success in business ; and the average of these Earnings of Management is high, partly because the class of employers contains, in addition to the able men that have been born within its ranks, a large share of the best natural abilities that have arisen among the lower ranks of industry. While *Profits* on capital invested in education is a specially important element in the incomes of professional men, *Rent* of rare natural abilities is a specially important element in the incomes of business men.

Thus, while General Walker regards as analogous to rent the whole of the excess of the earnings of the successful business man over those of the man who just gets *no* profits, I apply the analogy only to what may, at a rough guess, be put at a tenth part of this sum. I apply it only to the excess over the earnings of a business man who has average natural abilities and who makes sufficient profits to be a fair return for the trouble of giving a business education and a start in life, and to cover the difficulty of bringing him and his capital together.

I hope this answer, short and imperfect as it must needs be, will tend to clear away some confusions that have arisen in England as well as in America as to the relation in which my theory of business profits stands to that of General Walker. The forthcoming first volume of a work on Economics will contain a full statement of my position as to business earnings, and deal with certain difficulties which are evaded not only here, but in the *Economics of Industry*.

ALFRED MARSHALL.

ANALYSIS OF COST OF PRODUCTION.

The definition that makes abstinence an element in cost of production seems to me to be open to very serious objections. In the first place, as a matter of scientific accuracy, it is clear that production must have preceded abstinence. There can be no abstinence until there is wealth to abstain from. The first wealth abstained from must have had a cost of production as well as all later wealth, and in that cost abstinence can have had no place. Further, to quote the words of Cairnes,